Market Insights

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# Greek Déjà Vu All Over Again

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**Executive Summary**
Standish Global Macro Strategist Tom Higgins says that while the risks of an eventual Greek exit from the euro have increased, he believes European policymakers will take action to avoid that outcome in the short term. The good news, in his view, is that the global economy is probably better positioned for a Greek exit from the euro now than it has been over the last two years. Given the political and economic uncertainty in Europe, he expects some further shakeout in global financial markets, especially during the summer months when liquidity tends to dry up. Such volatility, he adds, could create buying opportunities in areas such as U.S. corporate credit and emerging markets debt where the economic fundamentals remain supportive of valuations.

## The Global Economic Expansion Can Weather a Greek Exit

For the third year running, investors are questioning the sustainability of the global economic expansion. Most of the concern continues to revolve around Europe where the latest purchasing managers' indexes and GDP figures suggest the region is bordering on recession. The problems in Europe are aggravated by the backlash against austerity evident in the recent elections, particularly in Greece. Additionally, the recent economic data in the United States and China has been disappointing.

Nevertheless, we believe that the global economic expansion will endure. In fact, we argue that the world economy is better positioned now than it was in the last two years to absorb a shock, including a Greek exit from the euro. However, we anticipate periodic bouts of market volatility as a result of political and economic uncertainty in Europe. We believe such volatility could create buying opportunities in areas such as U.S. corporate credit and emerging markets debt where the economic fundamentals remain supportive of valuations. At the same time, we at Standish are positioned for further weakness in the euro currency and we remain cautious on peripheral European government debt and European corporate credit markets.

## European Elections Imply Shift from Austerity to Growth

The French and Greek elections represent a sea change in Europe. France elected a Socialist president for the first time in 17 years, while extremists on both the left and right won parliamentary seats in Greece with no party winning an absolute majority. These results are the clearest sign yet that voters want to see less emphasis on austerity and more focus on economic growth in Europe.

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To this end, French President-elect François Hollande has promised to raise the minimum wage in France and pay for the increase with higher taxes on the wealthy. On the European level, he advocates the use of "project bonds" to finance infrastructure investment and a financial-transactions tax to finance new spending. The market response to Mr. Hollande's proposals has been muted, mostly because he has promised to stick to the outgoing government's commitment to reduce the budget deficit to 3% of GDP by 2013.

By contrast, political upheaval in Greece has unnerved investors and raised the possibility of a Greek exit from the euro. The radical left-leaning Syriza party, which won the second largest number of seats in the country's parliamentary elections, has rejected the austerity measures agreed to by the prior government as part of the €174 billion international bailout and debt restructuring in March. The resulting political impasse between supporters and opponents of the bailout package suggests new elections are likely by mid-June.

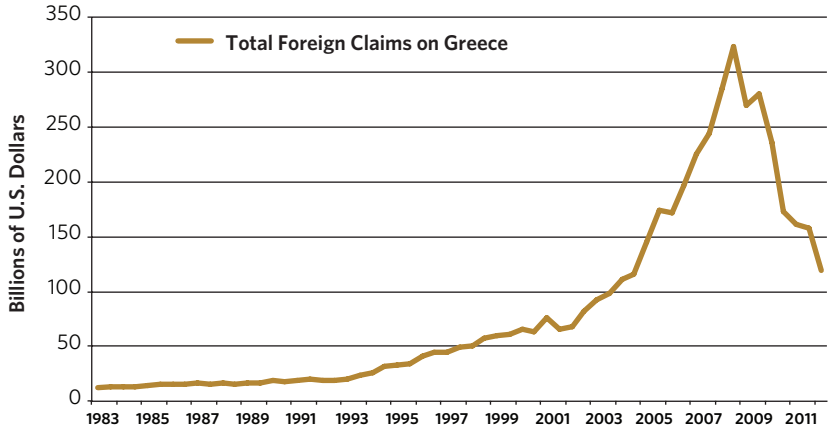
The good news is that the global economy is probably better positioned now to weather a Greek exit from the euro than it has been over the last two years.

While we acknowledge that the risks have increased, we do not expect Greece to exit the euro in the short term. Popular opinion polls suggest that the majority of Greeks still support membership in the euro and the costs of exit are simply too high.[1] The reintroduction of a new drachma would likely be followed by an immediate devaluation, debt default, capital flight, and a collapse of the banking system all of which would only increase suffering in Greece. Yet, without modifications to deficit targets and a further restructuring of Greece's debt burden, the risk of a Greek exit from the euro will increase over time. The International Monetary Fund expects Greece's debt-to-GDP ratio to top 160% of GDP in 2013, a level that is clearly unsustainable in the long-term.[2]

**Debate About Severity of Global Slowdown Intensifies**

The good news is that the global economy is probably better positioned now to weather a Greek exit from the euro than it has been over the last two years. Foreign banks have reduced exposure to Greek public and private debt from roughly $185 billion in September 2010 to $119 billion at the end of last year.[3] More recently, the European Central Bank's Long-Term Refinancing Operation (LTRO) has provided banks in Spain and Italy with enough liquidity to get through any temporary drying up of funding from the capital markets. During the first two rounds of the LTRO, the ECB provided roughly €1 trillion in three year loans to European banks.[4]

**Exhibit 1 – Foreign Exposure to Greece Has Declined Sharply**




Source: Bank of International Settlements Consolidated Banking Statistics as of April 2012.

1 Kapa Research survey, conducted May 9 and 10, 2012.
2 International Monetary Fund World Economic Outlook Database, April 2012.
3 Bank of International Settlements Consolidated Banking Statistics, March 2012.
4 European Central Bank Open Market Operations, April 2012.

However, a Greek exit from the euro would still be disruptive and would do little to solve Europe's problems. There is already evidence of contagion to other peripheral European markets, with Spanish and Italian bond yields rising back toward their highs from late last year. Moreover, the eurozone's permanent rescue fund, the European Stabilization Mechanism, is still insufficiently funded to bail out either of these economies were they to run into more serious problems. Concerns about these issues have brought the euro under some pressure, with the currency tumbling 3.8% versus the dollar to 1.2735 in the first half of May.[5] We expect further weakness in the currency as well as European corporate credit and peripheral European debt markets.

The deterioration in the European outlook might not be as worrying for global investors were it not accompanied by weaker data in the United States and China.

The deterioration in the European outlook might not be as worrying for global investors were it not accompanied by weaker data in the United States and China. Employment growth in the U.S. slowed sharply in April and recent Chinese data on industrial production and retail sales have been disappointing. Our view is that the U.S. slowdown is temporary and represents payback for the stronger data experienced at the beginning of the year due to the unusually mild winter. Barring a shock, we expect U.S. economic growth to remain in the 2% range in the second half of this year, with monthly jobs gains in the 150,000 to 175,000 range. In that environment, the Fed will likely remain on the sidelines, while providing assurances that it is prepared to act if necessary. That said, we think more dovish language from Fed officials can be expected if May's employment report looks anything like April's. Late this year, the U.S. fiscal drag due to take effect in early 2013 may begin to negatively affect consumer and business behavior as the rhetoric heats up ahead of the November election. Our base case is that legislators will take action to prevent full implementation of the $450 billion in tax hikes and spending cuts, but that some fiscal consolidation is likely.[6] We believe this could lead to some moderation in U.S. economic growth in the first half of 2013, which could bring the Fed back into play.

Treasury market is pricing in a higher probability of further quantitative easing from the Fed. Based on domestic factors, we would expect yields to move a little higher the closer we get to the end of the Fed's Operation Twist program in late June. Under this program, the Fed is selling short-dated Treasuries in its portfolio in order to buy longer-dated securities. Yet, Treasuries will likely remain anchored until the risks in Europe begin to abate.

As for China, we believe the recent slowdown is at least partly reflective of the government's efforts to rebalance the economy by reducing the dependence on exports and investment while increasing the share of consumption. The transition has proven to be bumpier than expected, but progress is being made which we think will increase the sustainability of the Chinese growth model for the long term. In the meantime, the government has adopted measures to stabilize economic growth.

Most recently, in mid-May the People's Bank of China (PBoC) lowered the reserve requirement ratio by 50 basis points to 20% for large banks and 18% for smaller banks.[7] The PBoC has also encouraged commercial banks to increase lending to power, railway and water projects. Furthermore, the Chinese government is reducing taxes for both individuals and corporations. We anticipate that these measures will begin to bolster economic activity in the second half of 2012.

Overall, we expect the economic divergence between Europe and the rest of the global economy to continue. In addition, we would not be surprised to see a further shake out in global financial markets given political uncertainty in Europe, especially during the summer months when liquidity tends to dry up. However, we believe this could create buying opportunities in areas such as U.S. corporate credit and emerging market debt, where the economic fundamentals are supportive of valuations.

5 Bloomberg, May 16, 2012.
6 Congressional Budget Office, March 2012.
7 Bloomberg, May 12, 2012.

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